No. 83-1966

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1983

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REPROSYSTEM, B.V., AND N. NORMAN MULLER;
*Petitioners,*

v.

SCM CORPORATION,
*Respondent.*

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**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit**

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## REPLY BRIEF FOR PETITIONERS

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EDWARD R. LEAHY
(Counsel of Record)
CHARLES G. COLE
RICHARD RUDA
STEPTOE & JOHNSON
1250 Connecticut Ave., N.W.
Washington, D.C. 20036
(202) 862-2000
*Attorneys for Petitioners*

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Petitioners contend that where fraud occurs in the course of face-to-face negotiations for the purchase of securities, the defrauded party should not be required to demonstrate the existence of a contract in order to sue under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1983). Petitioners demonstrated that this conclusion is consistent with (1) the underlying reasoning of *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); (2) this Court's identification in *Blue Chip Stamps* of the "[t]hree principal classes of potential plaintiffs" that lack standing pursuant to that

case, *id.* at 737; and (3) the evolution of the common law tort of misrepresentation and deceit as described by the Court in *Blue Chip Stamps*. Petitioners also pointed out that the magnitude and number of individually negotiated transactions, the opportunities for fraud in this context, and the absence of other effective remedies supported the recognition of standing. Respondent SCM Corporation has totally failed to rebut—or even to address—petitioners' arguments.

Instead, respondent simply reiterates the simplistic position of the court below that the existence of a contract under state law is a prerequisite to any suit for fraud under the federal securities laws. This view is not compelled by the language of the statute (which does not even use the word "contract"), by the legislative history (which indicates a broad intent to eliminate fraud in the disposition of securities),[1] or by the internal logic of *Blue Chip Stamps* and *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952) (which sharply distinguish between "public" offerings and face-to-face negotiations).[2]

Most importantly, respondent's view that the scope of section 10(b) is precisely delineated by the scope of state contract law reduces the antifraud provision to a mere superfluity. Under respondent's analysis, an individual is protected when he can show the existence of a contract—and therefore has all the protections of state contract law. But where fraud in the course of negotia-

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[1] *See* Petition at 15-16 & n.18.

[2] *See* Petition at 15 n.17.

Respondent, despite its heavy reliance on *Birnbaum*, failed to respond to petitioners' point that, at the time *Birnbaum* was decided, "the rule . . . was thought to relate only to public sales of securities . . . ." Eason v. General Motors Acceptance Corp., 490 F.2d 654, 658 (7th Cir. 1973) (Stevens, J.), *cert. denied*, 416 U.S. 960 (1974).

tions prevents the formation of a contract and causes other injury, the individual is left without a federal remedy.

The potential danger in this interpretation is well illustrated by *Northland Capital Corp. v. Silver*, 1984 Fed. Sec. L. Rep. (CCH) ¶ 91,496 (D.C. Cir. May 25, 1984), a case not cited by respondent. In *Northland*, as in this case, an individually negotiated securities transaction went awry just at the point of closing. The purchaser alleged that it had provided funds to the seller on the basis of forged financial statements and had received worthless securities in exchange. The *Northland* majority, invoking the same rigid interpretation of *Blue Chip Stamps* applied in this case, reasoned that, because there was no meeting of the minds of the parties and hence no contract under state law, plaintiff had no standing to sue under the federal securities laws.

One member of the *Northland* panel (Wald, J.) dissented vigorously. Not only did she disagree with the majority's analysis of state contract law, 1984 Fed. Sec. L. Rep. (CCH) ¶ 91,496 at 98,465,[3] but, more important, she criticized the majority for extending *Blue Chip Stamps* to shield "from the investor protection provisions of the Securities Exchange Act the very kind of fraudulent conduct which was a core concern of the drafters," *id.* at 98,464. The dissent noted that the holding and logic of *Blue Chip Stamps* had been ignored by the majority's overzealous invocation of state contract law principles:

> The stated purpose of *Blue Chip's* adoption of the *Birnbaum* standing doctrine was the prevention of 'strike suits' and the elimination of private damage

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[3] Hence, this type of case presents the anomaly of federal judges disputing the interpretation of state contract law in order to determine the existence of standing to sue for fraud under the federal securities laws.

> actions that would require a treacherous inquiry into the plaintiffs' subjective decisions regarding whether to invest or sell. *See* 421 U.S. at 740, 746.
>
> In this case, by contrast, Northland obviously does not fall within any of the three classes of plaintiffs that *Blue Chip* sought to eliminate.

*Id.* at 98,466.

The heart of *Blue Chip Stamps*, Judge Wald observed, was the Court's "balancing of the injuries that would flow from including or excluding nonsellers and nonpurchasers from the Rule's protection." *Id.* at 98,466-67 (footnote omitted). While the *Northland* majority's use of state contract law to preclude standing had "the 'disadvantage' of 'prevent[ing] some deserving plaintiffs from recovering damages that in fact have been caused by violations of Rule 10b-5[,]' 421 U.S. at 738," it had "none of the 'countervailing advantages' of . . . preventing 'strike suits' and litigation turning on subjective proof of what a plaintiff would have done in a hypothetical situation . . . ." *Id.* at 98,467. Consequently, the dissent concluded that the plaintiff in *Northland* had standing under the antifraud provisions of the federal securities laws.

Respondent's glib assertions notwithstanding, *Northland* thus demonstrates the importance and the recurring nature of the question presented by this petition.[4] It illustrates the opportunities for fraudulent conduct to occur in individually negotiated securities transactions prior to the formation of a contract. Moreover, *Northland* is yet another example of an appellate court requiring strict compliance with state contract law as a predicate for stating a federal securities claim—even though none of the concerns of the *Blue Chip Stamps* majority

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[4] "This case presents a recurring issue . . . under the federal securities laws." Northland Capital Corp. v. Silver, 1984 Fed. Sec. L. Rep. (CCH) ¶ 91,496 at 98,456.

are present. The dissent in *Northland* thus evidences the growing perception that federal appellate courts are far exceeding the logical limits of the *Blue Chip Stamps* opinion.

Respondent SCM also argues that there is no need for federal securities law coverage in this case because sufficient protection against fraud exists under state law. Brief in Opposition at 6. This argument proves too much for, under this view, a federal antifraud statute would not have been necessary at all. Congress was well aware of the existence of such state law remedies when it enacted the antifraud provisions of the federal securities laws. *Cf. United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 868 (1975) (Brennan, Douglas & White, JJ., dissenting) ("Congress contemplated concurrent state and federal regulation in enacting the securities laws."). Where, as here, state law remedies have proven inadequate to protect against fraud in connection with the sale of securities, the federal statute was designed to provide an alternative and more efficacious remedy.[5]

The question raised by this petition is thus both substantial and recurring. Moreover, it will assume even greater importance if this Court concludes, in *Vista Resources, Inc. v. Seagrave Corp.*, 710 F.2d 95 (2d Cir. 1983), *cert. granted*, 52 U.S.L.W. 3827 (U.S. May 14, 1984) (No. 83-1084), that the federal securities laws apply to sales of large blocks, or all, of the stock of a business. As petitioners have noted, the reasons why the securities laws should be applied to such negotiated

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[5] In its brief, respondent cites the district court's finding that SCM's conduct in its negotiations with petitioners was not fraudulent but arose "simply out of [a] careful financial analysis." Brief in Opposition at 3 (quoting 522 F. Supp. at 1273). Not only is this finding suspect as a matter of law, but, significantly, the Second Circuit refrained from affirming the district court on this point. The court of appeals instead based its holding with respect to petitioners' federal securities law claims solely on its interpretation of Birnbaum v. Newport Steel Corp. *See* 727 F.2d at 265.

transactions are the very reasons why standing should be found in this case.

For the foregoing reasons, the petition for certiorari should be granted.

Respectfully submitted,

EDWARD R. LEAHY
(Counsel of Record)
CHARLES G. COLE
RICHARD RUDA
STEPTOE & JOHNSON
1250 Connecticut Ave., N.W.
Washington, D.C. 20036
(202) 862-2000
*Attorneys for Petitioners*

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